(5)

No. 83-832
IN THE
Supreme Court of the United States

October Term, 1983

HAROLD T. and MARIE B. PAULSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

OPENING BRIEF FOR THE PETITIONERS.

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Question Presented for Review.

Whether the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, in which all the stock of the state association is exchanged for ownership savings accounts representing share interests in the federal mutual association, qualifies as a reorganization upon which taxable gain is deferred under sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code of 1954, as amended (the "Code").

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OPINIONS BELOW.

The opinion of the court of appeals (Pet. App. 20-32) is reported at 716 F.2d 563. The opinion of the Tax Court (Pet. App. 1-18) is reported at 78 T.C. 291.

JURISDICTION.

The judgment of the court of appeals (Pet. App. 33) was entered on August 16, 1983. The Petition for a Writ of Certiorari was filed on November 14, 1983, and was granted on February 21, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED.

The relevant portions of sections 354, 368 and 7701 of the Internal Revenue Code of 1954, as amended (the "Code"), and of 12 C.F.R. § 544.1(b) as in effect on July 1, 1976, are set forth in the Appendix to the Petition for Certiorari at 34-35.

STATEMENT OF THE CASE.

The petitioners, Harold and Marie Paulsen, were shareholders of Commerce Savings and Loan Association of Tacoma ("Commerce") (Jt. App. 15). On July 1, 1976, pursuant to a Plan for

Merger, Commerce merged into Citizens Federal Savings and Loan Association ("Citizens Federal") (Jt. App. 15-16). In the merger, all the guaranty stock of Commerce, including that owned by the petitioners, was converted into Citizens Federal ownership accounts (Jt. App. 15-16, 63-64) "*representing share interests* in [Citizens Federal]." Charter K (Rev.) ¶ 3(6) (Jt. App. 37); 12 C.F.R. § 544.1(b) (1976) (Pet. Br. App. 35) (emphasis added). The petitioners received passbook and certificate share accounts (referred to as "Certificates of Deposit") with an aggregate face value of $209,508 in exchange for 17,459 shares of Commerce guaranty stock, in which they had a tax basis of $56,802 (Jt. App. 18).

Prior to the merger, Commerce was a Washington State chartered savings and loan association owned by the petitioners and the other holders of its guaranty stock (Jt. App. 14-15) (Pet. App. 3, n.2). Citizens Federal, the surviving entity, was and is a federal corporation chartered as a mutual savings and loan association under Charter K, Revised (Jt. App. 15, 36). Like all such corporations, it is owned exclusively by its share account holders. Charter K (Rev.) ¶¶ 3(6) and 10 (Jt. App. 37, 44-45); 12 C.F.R. § 544.1(b) (1976) (Pet. App. 35); 716 F.2d at 564 (Pet. App. 21). In the event of the liquidation or dissolution of Citizens Federal, its account holders are entitled to a pro rata distribution of its assets. Charter K (Rev.) ¶ 10 (Jt. App. 44-45).

On matters which require the approval of the members of the association, each holder of a Citizens Federal account is entitled to one vote for every $100 (or fraction thereof) of the amount invested in his account, up to a maximum of 400 votes. A borrower from Citizens Federal is regarded as a *non-proprietary member* and is accorded one vote. Charter K (Rev.) ¶ 4 (Jt. App. 38-39).

Citizens Federal's charter and bylaws provide that twice each year its net earnings and any surplus are to be distributed to account holders on a pro rata basis. All distributions on accounts are expressly dependent upon the financial success of the association and are made only out of profits of the enterprise, ratably according to the size of the investment. Charter K (Rev.) ¶ 10

(Jt. App. 43-44). The amount of the distribution, if any, is determined and declared periodically by the Board of Directors, subject to regulatory limitations in effect at the time. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). If the association is not profitable or its reserves or surplus are too low, no distribution will be made on any account, and the association is liable for none. *See* Charter K (Rev.) ¶ 10 (Jt. App. 43-44); 12 C.F.R. § 563.14 (1976) (Pet. Br. App. 4).

Under the terms of its charter, Citizens Federal will honor written requests to withdraw from the association by its account holders within thirty days, so long as funds are available to honor the redemption requests without jeopardizing the financial well-being of the institution. If the association is unable to pay all withdrawal requests within 30 days, it will institute a revolving system, paying withdrawal requests of up to $1000 in the order received to the extent that receipts exceed the amount required for normal operations. Charter K (Rev.) ¶ 6 (Jt. App. 40). Citizens Federal's charter specifically provides that "[*h*]*olders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors*." Charter K (Rev.) ¶ 6 (Jt. App. 41) (emphasis added).

Its charter also gives Citizens Federal the right, under certain specified circumstances and when there would be no impairment of capital, to redeem accounts, by lot or otherwise as the Board of Directors may determine. The redemption price must be "the full value" of the account, but may not be less than the account holder would receive if he withdrew from the association. Charter K (Rev.) ¶ 7 (Jt. App. 41-42).

The accounts issued by Citizens Federal in the merger had the same rights as all other Citizens Federal share accounts, but were subject to a withdrawal restriction of at least one year (Jt. App. 17). In the merger agreement, Citizens Federal agreed to make loans to the former Commerce shareholders against the security of their accounts at a slightly lower interest rate (0.5% less) than that it normally charged its account holders for similar loans (Jt. App. 18).

On audit of the petitioners' 1976 federal income tax return, the Commissioner asserted a deficiency based on his determination that petitioners were required to recognize gain in 1976 in an amount measured by the difference between their adjusted tax basis in the Commerce guaranty stock they surrendered in the merger and the face value of the Citizens Federal share accounts they received (Jt. App. 14) (Pet. App. 6). He issued a statutory notice of deficiency, and the petitioners filed a petition in the United States Tax Court for redetermination of the asserted deficiency (Jt. App. 3, 14). They contended that the merger was a reorganization of the two savings and loan associations within the meaning of section 368 of the Code and that recognition of any gain they realized on the exchange was therefore deferred by Code section 354(a)(1) until such time as they withdrew or otherwise disposed of the Citizens Federal accounts they received in the merger (Jt. App. 3-4) (Pet. App. 6).

The Tax Court, in an opinion by Judge Featherston, agreed with the petitioners. It held that the merger was a reorganization under section 368(a)(1)(A) of the Code and that, accordingly, the petitioners recognized no gain or loss on their exchange by virtue of section 354(a)(1). A decision was entered in the petitioners' favor on March 8, 1982. *Paulsen v. Commissioner*, 78 T.C. 291 (1982) (Pet. App. 1-18).

The Commissioner appealed the Tax Court decision to the Court of Appeals for the Ninth Circuit. The Ninth Circuit, departing from a substantial body of precedent, reversed the Tax Court. The court of appeals concluded that a merger of a stock-type savings and loan association into a mutual savings and loan association does not constitute a reorganization exempt from recognition of gain or loss under the Code. 716 F.2d 563, 564, 569 (1983) (Pet. App. 20, 31-32).

SUMMARY OF ARGUMENT.

The reorganization provisions of the Code provide a comprehensive series of definitions which must be met in order to defer the recognition of gain or loss on the transfer of property or stock in a corporate combination or restructuring. In addition to the literal compliance with the statute, however, the transaction must

also not be subject to certain judicially imposed limitations. These judicial limitations have been broadly classified as the "business purpose" and "continuity of proprietary interest" doctrines. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.03 (4th ed. 1979). If the transaction meets the statutory requirements and is not subject to these judicial limitations, a corporation recognizes neither gain nor loss on the transfer of its property for stock or securities in another corporation that is a party to the reorganization, and the shareholders may exchange their stock or securities for new instruments without recognizing gain or loss. The "tax cost" imposed by the Code for a reorganization is a carry-over adjusted basis in the property or stock transferred or exchanged. Thus, the gain or loss that went unrecognized at the time of the exchange will be recognized when the property is subsequently sold or the investment liquidated. The issue in this case is the proper application of the judicial "continuity of proprietary interest" limitation which has been developed by this Court in a series of cases. *E.g.*, *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

When the petitioners exchanged their stock in a state savings and loan association for share interests in a federal mutual savings and loan association, the transaction complied with the statutory requirements for a reorganization. The Code explicitly states that an association is a corporation, a share in an association is stock, and a member in an association is a shareholder. I.R.C. § 7701(a)(2), (3), (7) & (8). Thus, before the exchange the petitioners were shareholders in a corporation, and after the exchange they were shareholders in a corporation. Their investment remained in corporate solution and they continued their old investment in the new combined enterprise.

The continuity of proprietary interest doctrine requires that the petitioners retain a continuing interest in the reorganized corporation. The respondent's position, accepted by the Ninth Circuit Court of Appeals below, requires a *comparison* of the ownership

interest exchanged with the ownership interest received. Because the respondent and the Ninth Circuit found the relationship of the petitioners to the reorganized corporation had changed, they concluded that gain had to be recognized. The cases decided by this Court, however, make it clear that the inquiry is not whether the shareholders of a merged corporation received a larger or smaller or different kind of proprietary interest than they surrendered, but whether a proprietary interest was received. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935). Since a mutual association's account holders are its stockholders and its only owners, they by definition have a definite and substantial proprietary interest in its affairs.

The petitioners' share interests in the surviving federal mutual savings and loan association are represented by passbook and certificate accounts. While such accounts may in some ways resemble bank deposits, the inquiry cannot stop at that superficial level. The respondent has admitted and the Ninth Circuit Court of Appeals found that the account holders of a federal mutual savings and loan association hold all of the proprietary rights and interest in the association. The charter and bylaws of Citizens Federal also make it clear the account holders have substantial rights as owners of the association. These include the right to vote, elect the Board of Directors, receive financial reports and approve major changes in policy and organization.

Equally indicative of their proprietary interest in the association is the fact that Citizens Federal's account holders share pro rata in the increase or decrease in value of its net assets which would be realized upon liquidation of the association or acquisition by another corporation. The account holders are also dependent upon the profitability of the association for any return on their investment, because they can only receive dividends from the profits of the enterprise, which must first be declared by the Board of Directors. Charter K (Rev.) and Bylaws (Jt. App. 36-53). *Cf. Tcherepnin v. Knight*, 389 U.S. 332 (1967).

The legislative history of the applicable Code provisions demonstrates that the types of instruments that may be received in a

reorganization are not limited to what is commonly referred to as "stock." The definitions of "stock" to include shares in an association and of "corporation" to include associations have been in the Code for many years and have been repeatedly reenacted by Congress. There is no indication whatsoever that federal mutual associations such as Citizens Federal were to be excluded from the reorganization sections of the Code.

For many years, reorganizations such as the one in issue took place with the respondent's blessing. Not until the mid-1960's did the respondent reverse his position on the issue presented in this case. Yet there has been no change in the law.

While it is conceded that the Commissioner has the right to change his position, that change must be based on a logical interpretation of the law. The Commissioner's published ruling holds that there can be a reorganization between two mutual savings and loan associations under the Code. Rev. Rul. 69-3, 1969-1 C.B. 103. Presumably in that ruling the reorganization met both the literal language of the Code and the judicially imposed limitations, so that the shareholders of the merged mutual association had a continuing proprietary interest in the reorganized entity. Yet the Commissioner in the same breath concluded that the merger of a stock-type association into a mutual association is not a reorganization. Rev. Rul. 69-6, 1969-1 C.B. 104.

In his rulings, the Commissioner has ignored the decisions of this Court and has instead examined whether the proprietary interest received has changed compared with the proprietary interest surrendered, rather than whether a proprietary interest in the ongoing enterprise *was in fact* received. This leaves the respondent in the untenable position of contending that share accounts are equity interests for some reorganizations but not for others. The Code and judicial decisions make no such distinction.

The issue in this case has been considered by a number of courts in the past and each has rejected the respondent's position. Those cases relied on the decisions of this Court and held there *can* be a reorganization involving the merger of a stock-type savings and loan association into a mutual savings and loan association. Each of the courts, in a well-reasoned opinion, held

that the continuity of proprietary interest test was satisfied. It is submitted that these courts properly applied the test, whereas the respondent and the Ninth Circuit Court of Appeals below did not. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Owens v. Commissioner*, T.C. Memo. 1983-302 (May 26, 1983); *Paulsen v. Commissioner*, 78 T.C. 291 (1982); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980).

Even more disturbing than the immediate tax impact on the petitioners, however, is that the position of the respondent and the decision by the court of appeals below unduly interfere with legitimate business combinations and discriminate against mutual savings and loan associations in favor of stock-type savings and loan associations. Based on the Code and judicial decisions, there is no reason why a mutual association should not be able to compete with a stock-type savings and loan association for the acquisition of a stock-type association. Yet unless this issue is resolved in favor of the petitioners, a stock-type association and its shareholders would incur an immediate tax if the association were acquired by a mutual association while, on the other hand, they could enter into a reorganization with another stock-type association. The result is that a mutual association would not be able to acquire a stock-type association or would have to pay an additional amount to compensate for the immediate tax impact. There is no evidence that Congress ever intended to discriminate in such a manner against mutual savings and loan associations. To the contrary, every indication is that Congress has sought to encourage the savings and loan industry.

In addition, the test adopted by the Ninth Circuit Court of Appeals affects *all* reorganizations. If followed, it would require courts to examine the interest received in each reorganization to see if it has really changed from the interest surrendered. That

is not the test that has been established by this Court and long relied upon by taxpayers. To avoid this unnecessary confusion and unfairness, the decision below must be reversed.

ARGUMENT.

I.

THE CONVERSION OF COMMERCE STOCK INTO CITIZENS FEDERAL SHARE ACCOUNT INTERESTS ON THE MERGER OF COMMERCE INTO CITIZENS FEDERAL WAS A STOCK-FOR-STOCK EXCHANGE IN PURSUANCE OF A PLAN OF REORGANIZATION WITHIN THE MEANING OF SECTIONS 368(a)(1)(A) AND 354(a)(1) OF THE CODE RESULTING IN NO CURRENT GAIN OR LOSS ON THE EXCHANGE.

This case is one in a series of attacks by the respondent over the last fifteen years, challenging bona fide reorganizations involving a guarantee stock-type savings and loan association and a mutual savings and loan association where the mutual association is the surviving entity. *E.g.*, *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Each of these cases was decided adversely to the respondent.

The United States Tax Court in its decision below thus joined an unbroken line of authority rejecting the respondent's contention that the exchange by a mutual savings and loan association of its share accounts for all the guarantee stock of a stock-type savings and loan association pursuant to a statutory merger of the two business entities does not constitute a reorganization. The issue was so well-settled that the respondent, after losing in *Capital*, decided not to litigate it further "at the corporate level." See Action on Decision No. CC-1981-99, at 2. Yet, in the instant case, and in many others pending in the lower courts, he has

continued to refuse reorganization treatment to the shareholders in the same type of transaction while fully recognizing that any distinction between the tax treatment of the corporation and its shareholders is untenable. As the respondent conceded in his response to our Petition for Certiorari: "[p]arallel consequences for the corporation and its shareholders flow automatically from [the] determination [that a merger of the type in issue is a reorganization]." Resp. Br. on Pet. at 7, n. 2.

On appeal of this case to the Ninth Circuit, the respondent finally prevailed on his contention that a merger of a stock-type savings and loan association into a mutual savings and loan association does not come within the reorganization provisions of the Code. To reach that result, the court of appeals had to create and apply a version of the "continuity of proprietary interest" test contrary to the principles enunciated by this Court. Both the respondent and the Ninth Circuit recognized that the holding below is in direct conflict with the decisions of all the other courts which found a qualifying reorganization on substantially identical facts.

A. The Decisions of This Court Make It Clear That a Bona Fide Combination of Both the Corporate Ownership and the Business Operations of Two Entities Within the Literal Terms of the Code Will Qualify as a Reorganization Upon Which No Gain or Loss Is Currently Recognized.

This Court has, on at least 11 occasions, been called upon to determine whether a particular transaction qualified under the then applicable revenue acts as a "reorganization" upon which gain or loss was not recognized.[1] In its decisions, the Court has

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[1]*Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Bazley v. Commissioner*, 331 U.S. 737, *reh'g denied*, 332 U.S. 752 (1947); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940); *United States v. Hendler*, 303 U.S. 564, *reh'g denied*, 304 U.S. 588 (1938); *Groman v. Commissioner*, 302 U.S. 82, *reh'g denied*, 302 U.S. 779 (1937); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Helvering v. Watts*, 296 U.S. 387 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

instructed that, to be characterized and taxed as a reorganization, the transaction in question must (i) come within the language of the act; and (ii) effect a bona fide restructuring or readjustment of the ownership and business operations of the entity or entities involved. This Court has never denied a transaction reorganization treatment where both of the foregoing requirements are met.

1. The Transaction at Issue Comes Within the Literal Terms of the Code.

Section 368 of the Code, which sets forth the types of corporate transactions that constitute a "reorganization," includes within the meaning of that term "a statutory merger or consolidation." I.R.C. § 368(a)(1)(A). In conjunction with section 368, Code section 354 provides that

> [n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

I.R.C. § 354(a)(1). Congress defined the term "corporation" in the Code to include an association, the term "stock" to include "shares in an association" and the term "shareholder" to include a "member in an association." I.R.C. § 7701(a)(3), (7) & (8).

By their express terms, these Code sections apply to the transaction at issue in this case. The petitioners exchanged stock for "shares in an association" in "pursuance of the plan of reorganization," a statutory merger. A literal reading of the Code therefore exempts the petitioners' exchange from recognition of gain or loss, but the Ninth Circuit declined to apply the plain language of the Code.

2. The Only Issue in This Case Is Whether the Merger Satisfied the Continuity of Proprietary Interest Test.

The requirement that a transaction, to qualify as a reorganization, must effect a bona fide restructuring of both the business ownership and operations of the entities involved is not found within the language of the Code. Instead, it is a judicially evolved prerequisite intended to assure that transactions which are tech-

nically encompassed within the literal terms of the statute, but do not fulfill its purpose, will not receive reorganization treatment. It recognizes, however, that Congress intended to encourage valid business readjustments or combinations by deferring taxation on such transactions until the owners of the enterprises actually withdraw their investment in the business assets, "even if the property received in exchange has a readily realizable market value." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (discussing the Revenue Act of 1921).

Where the business operations of the entities involved are continued after the transaction, this Court has enunciated only two exceptions to reorganization treatment for transactions otherwise within the plain language of the statutes. The first, which is directed at tax-avoidance devices undertaken for no real business purpose, is set forth in the landmark reorganization case of *Gregory v. Helvering*, 293 U.S. 465 (1935). The Court there held that "an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to [make a tax-free dividend of property to the taxpayer]," lay "outside the plain intent of the statute." *Id.* at 469-70.

The instant case stands in stark contrast to *Gregory*. In *Gregory*, a sole shareholder had devised a scheme structured in form as a reorganization in an effort to avoid dividend treatment on the distribution to her of certain stock owned by the corporation, whereas here, two unrelated ongoing business entities have joined together for the mutual benefit of both and continued to operate as one enterprise with the same original owners. Unlike the transaction in *Gregory*, the merger of Commerce into Citizens Federal served all the corporate purposes of a reorganization. The respondent has never contended that it was a scheme to avoid tax. Without question, the transaction at issue was a "bona fide business move" which the "details of corporate affairs" reveal accomplished far more than tax deferral, and therefore does not come within the *Gregory* exception. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

The second exception to reorganization treatment has been developed by this and other courts to separate pure sales from true business readjustments. It applies to transactions structured in form as reorganizations but in which the owners of the acquired entity have not retained a material proprietary interest in the reorganized enterprise. That is, they have not continued as owners of the business. In cases where such continuity of proprietary interest does not exist, the courts have found the transaction to be nothing more than a sale and have denied reorganization treatment to both the corporations and the shareholders involved. Thus, in *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940) (receipt of debt securities, and no stock) and *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (receipt of cash and short term promissory notes) the Court held there was not a reorganization. On the other hand, in *Helvering v. Watts*, 296 U.S. 387 (1935) (receipt of stock and mortgage bonds), *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935) (receipt of cash and voting trust certificates representing common stock) and *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (receipt of consideration comprised 38 percent of nonvoting preferred stock and the rest cash) this Court found valid reorganizations.

Except for the decision of the court of appeals below, every court that has applied the continuity of proprietary interest test to the merger of a stock-type savings and loan association into a mutual savings and loan association has found the test satisfied and has therefore upheld the transaction as a reorganization. The petitioners submit that the decision of the Ninth Circuit is in direct conflict with this Court's (i) interpretation of the Code provisions governing reorganizations, and (ii) characterization of the nature of an account holder's legal interest in a mutual savings and loan association.

B. The Ninth Circuit Erred in Its Interpretation of the Continuity of Proprietary Interest Test as Enunciated by This Court.

The continuity of proprietary interest test as defined by this Court in varying factual situations and applied by other courts over the years has been summarized by the Court of Appeals for

the Fifth Circuit in the following often-quoted passage:

> While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear . . . [there must be] a showing: (1) that the transferor * * * or its shareholders retained a *substantial proprietary stake* in the enterprise represented by a *material interest* in the affairs of the transferee corporation, and, (2) that such *retained interest* represents a *substantial part of the value* of the *property transferred*.

Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

This Court has held that the interest in the affairs of the surviving entity which is received by the acquired corporation's shareholders must be "more definite than . . . ownership of its short-term purchase money notes" and that the test is not satisfied if the sole consideration received by those shareholders consists of securities, regardless of their term. *Minnesota Tea Co.*, 296 U.S. at 385 [quoting *Pinellas Ice & Cold Storage Co.*, 287 U.S. 462 (1933)]; *Le Tulle v. Scofield*, 308 U.S. at 420-21. In such cases, the transaction is nothing more than a sale and does not "partake of the nature of a [reorganization]." By contrast, voting trust certificates representing common stock, or nonvoting preferred stock which is redeemable at stated intervals and has no voice in the control of the corporation except on default of dividend payments, will satisfy the test. *Minnesota Tea Co.*, 296 U.S. at 381, 386; *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 376-77 (1935). Therefore, the instrument conveying the requisite proprietary stake in the enterprise must represent an equity interest in the transferee corporation, and that type of instrument must be received in exchange for "a substantial part of the value" of the stock, securities or assets transferred.

Although the Ninth Circuit briefly referred to certain of the foregoing principles, it applied an incorrect standard to the facts before it in this case. It stated that the "*critical question*" in determining if a reorganization has occurred is "*whether the position of the shareholder in the reorganized entity has really changed: has his risk increased or decreased? is his investment more or less liquid?*" 716 F.2d at 569 (Pet. App. 30) (emphasis

added). The court of appeals then concluded that, although the petitioners had remained owners of the surviving association, they had "converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one." "[U]nder [those] circumstances," the court of appeals said, it "[saw] no reason why . . . the gain they experienced by doing so should not be recognized." *Id.* (Pet. App. 31).

The "reason," the petitioners respectfully submit, is that the statute and case law provide otherwise. This Court has repeatedly rejected the requirement, urged by the respondent and imposed by the Ninth Circuit, that the relationship of the shareholders of the acquired corporation to the assets conveyed cannot be "really changed." In *Minnesota Tea*, where the acquired corporation's shareholders received voting trust certificates representing common stock worth approximately $540,000 and an additional $425,000 in cash from the acquiring corporation, the Commissioner also argued that the transaction did not qualify as a reorganization because it "substantially changed the relation of the taxpayer to its assets. . . ." 296 U.S. at 384. This Court responded:

> The transaction here was no sale, *but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser*.
>
> *True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute*. Also, a large part of the consideration was cash. This, we think, is permissible so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets.

Id. at 386 (emphasis added).

Similarly, in *John A. Nelson Co.*, 296 U.S. at 377, the acquired corporation's shareholders received only *nonvoting* preferred stock of the acquiring corporation, plus cash. Reversing the Tax Court's conclusion that no reorganization had occurred, this Court noted that the owner of preferred stock (even nonvoting, redeemable preferred) "is not without substantial interest in the affairs of the issuing corporation. . . ." *Id.* at 377. Accordingly, the Court

refused to deny reorganization status to the transaction simply because the nature of the proprietary interest retained by the acquired corporation's shareholders in the reorganized enterprise had substantially changed in relation to the ownership interest they had held in the acquired corporation. *Id.* at 377.

The respondent's published rulings demonstrate that it is his position, the position now endorsed by the Ninth Circuit, that the nature of the interest received by the petitioners is not controlling, but that it is the perceived degree of change in the proprietary interest received that is controlling. For example, the Commissioner has ruled publicly that accounts in mutual savings and loan associations constitute "stock" if exchanged for other savings accounts or for the stock of a guaranty stock-type association; yet these same accounts are not "stock" if received in exchange for guaranty stock. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 (merger of two mutual savings and loan associations constitutes an "A" reorganization) and Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type savings and loan association is a tax-free reorganization) *with* Rev. Rul. 69-6, 1969-1 C.B. 104 (merger of a guaranty stock-type association into a mutual association constitutes a "sale of assets" and not a reorganization within the meaning of section 368(a)(1)(A)). There can be no doubt, therefore, that the Commissioner seeks to tax what he views as a change in the nature of the proprietary interest, as precluded by the decisions of this Court.

That the court of appeals in fact reached its conclusion based on what it perceived as differences between the ownership interest relinquished by the petitioners and the ownership interest they received in Citizens Federal is evidenced by its refusal to give any weight whatsoever to the actual legal rights which define the equity nature of a Citizens Federal share account. For instance, the court of appeals summarily dismissed the account holders' right to vote, because it found "the voting rights received by Citizens depositors are quite dissimilar to those of holders of equity interest in other corporations." 716 F.2d at 567 (Pet. App. 27). In the same vein, the appeals court stated that "though

Citizens does indeed distribute what it calls 'dividends,' " it "pays a fixed, preannounced rate on all accounts." From this the Ninth Circuit concluded that the dividends are "in practice" [although not in legal reality] . . . identical in all essential respects to the interest paid by stock savings and loan associations [on nonproprietary deposits]." *Id.* at 567 (Pet. App. 27).

The appeals court also attached no weight to the fact that Citizens Federal's account holders own all the underlying assets of the association. At the same time, it freely admitted that, "[f]rom the Association's point of view, *there can be little doubt that the passbook accounts are equity* in the sense that they represent the entire capital of the Association." *Id.* at 569 (Pet. App. 30) (emphasis added). This the Ninth Circuit found "irrelevant" to its determination of whether the transaction constituted a "reorganization." (Pet. App. 30).[2]

The absurdity of the test used by the Ninth Circuit is readily apparent when applied to other bona fide reorganizations, because the degree of risk or liquidity of a share of stock in the acquired corporation is rarely exactly comparable to that of a share of stock in the acquiring entity. In a closely held corporation, for example, the stock may be virtually unsaleable unless offered in an entire controlling bloc, whereas a shareholder in a corporation such as IBM can liquidate his investment in a few seconds merely by placing a call to his broker. Yet no court has ever held that a merger of such dissimilar entities would not qualify as a reorganization.

In sum, the court of appeals in this case chose to ignore the fact that the share accounts received by the petitioners *are equity* and instead focused its analysis exclusively on the *change* be-

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[2]Based on the analysis set forth in its opinion, the court of appeals would apparently not consider an exchange of common stock for normal preferred stock, including that issued in *John A. Nelson Company*, 296 U.S. 374, to come within the reorganization provisions of the Code. After all, such stock generally has *no* voting rights, pays a stated, fixed rate of dividends, is entitled to receive only its par (paid-in) value upon liquidation, and is usually redeemable after a period of time or under certain circumstances.

tween the equity interest given up and the equity interest received. Under the standards developed by this Court, which have been consistently applied for years by the lower courts, the transaction at issue cannot be denied reorganization treatment simply because the risk and liquidity of the proprietary interest held by the shareholders of the acquired association in the reorganized enterprise may have "really changed." The question to be decided is whether those shareholders in fact continued as owners of the business. If that question is answered in the affirmative, as even the Ninth Circuit conceded it must be, the petitioners and other former Commerce shareholders "acquired a definite and material interest in [Citizens Federal] represent[ing] a substantial part of the [stock] transferred," and their transaction therefore "partook of the nature of a reorganization." *Minnesota Tea Co.*, 296 U.S. at 385-86; *Pinellas Ice & Cold Storage Co.*, 287 U.S. at 469.

C. Citizens Federal's Savings Share Accounts Are Equity Interests Which Satisfy the Continuity of Proprietary Interest Test.

1. The Charter and Bylaws of Citizens Federal Establish That Its Account Holders Are the Sole Owners of the Association and That Its Accounts Represent an Equity Interest in the Association.

The respondent has admitted and the Ninth Circuit Court of Appeals has found that Citizens Federal's account holders hold all the proprietary rights and interest in the association (except for a nominal vote granted borrowers). They are the sole owners of its assets. Brief for the Appellant on Appeal to the Ninth Circuit Court of Appeals at 3-4; 716 F.2d at 564 (Pet. App. 21, 30).

As a corporation chartered by the federal government under Charter K (Revised), Citizens Federal raises its capital in the only permissible form: by accepting payments on accounts which "*represent share interests in the association*."[3] Charter K (Rev.)

[3]Both the Commissioner and the Ninth Circuit attach considerable weight to the current popular use of terms such as "interest" and "depositor" to describe what traditionally were accurately denominated "dividends" and "shareholders." They also assert, without discussing

¶ 3(6) (Jt. App. 37) (emphasis added). The only way to become an equity owner in Citizens Federal is to become the holder of such a share interest, or savings account, just as the only way to become an equity owner of any corporation is to become the holder of its stock. Like ordinary stock certificates, the passbooks or certificates representing these accounts are not negotiable, but are, upon request, transferable on the books and records of the association. 12 U.S.C. § 1464(b)(1) (1976).

Citizens Federal account holders also have all the rights normally associated with stockholders. Except for the one vote each accorded borrowers, they have the full voting power, and thus the ultimate control over the association. Charter K (Rev.) ¶ 4 (Jt. App. 38). Like typical shareholders, they elect the Board of Directors, receive full annual financial reports on the association, can amend its charter and bylaws, and have the right to approve major changes of policy and organization. Charter K (Rev.) ¶¶ 5, 11 (Jt. App. 39, 45); Bylaws ¶¶ 1, 11 (Jt. App. 45-46, 51-52); *see* 12 C.F.R. §§ 546.4 and 546.5 (1976) (Pet. Br. App. 1-3); *see also* 12 C.F.R. § 546.2(e) (1983). Only members of the association are eligible to become or remain directors. Charter K (Rev.) ¶ 5 (Jt. App. 39).

As its equity owners, Citizens Federal's account holders are the sole beneficiaries of any increase in value of its net assets.

the underlying rights and characteristics of the accounts, that the "practice" of making regular distributions of earnings makes the right to share in profits "illusory" and converts the distributions into interest. Brief for Appellant on Appeal to the Ninth Circuit Court of Appeals at 16, n. 8; 716 F.2d at 567-68 (Pet. App. 27-28). Taken to its logical extension, that argument would make the right to share in profits of preferred stockholders in most successful corporations "illusory." It is, of course, the actual legal rights of the account holders which must control the outcome of this case, not the terminology that the respondent, the Federal Home Loan Bank Board or even the associations themselves have chosen to use. *Gregory v. Helvering*, 293 U.S. 465 (1935). Furthermore, ignorance or misconceptions on the part of account holders or the public in general are not grounds for treating the fundamental legal relationship between an association and its owners as other than it really is. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714, 717 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962).

They are entitled to share equally, on a pro rata basis according to the investment in their accounts, in the residual assets of the association upon its liquidation (Charter K (Rev.) ¶ 10 (Jt. App. 44-45)), and they have the power, subject to Federal Home Loan Bank Board ("FHLBB") approval, to cause Citizens Federal to be liquidated and dissolved. 12 C.F.R. § 546.4 (1976) (Pet. Br. App. 1-2). *Nor is this mere theory*, for such liquidations have in fact occurred,[4] and liquidation surpluses exist even where the association is in receivership and the liquidation is involuntary. *See, e.g., Lanigan v. Apollo Savings*, 52 Ill. 2d 342, 288 N.E. 2d 445, 448 (1972) (involving a state stock-type association). Similarly, Citizens Federal's account holders would realize the increased value of their investment if their corporation were acquired by another. *See, e.g.*, Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type association wherein each shareholder in the mutual association received guaranty shares which had a fair market value equal to his pro rata interest in the undivided profits and reserves of the mutual association on the date of the exchange).[5] *Id.* at 55.

Although federal law and Charter K (Revised) *permit* it to raise an unlimited amount of capital, Citizens Federal's bylaws contain provisions to protect its owners if acceptance of additional capital would jeopardize or diminish their interests. The Board of Directors may "limit payments on capital which may be accepted"

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[4]*See* Russell, *Savings and Loan Associations*, 98 (2d ed. 1960) (reporting that "numerous" voluntary liquidations occurred at or above par from 1930 to 1954); *see also Federal Home Loan Bank Board v. Elliott*, 386 F.2d 42, 45 (9th Cir. 1967), *cert. denied*, 390 U.S. 1011 (1968) (anticipated liquidation surplus of Long Beach Federal Savings and Loan Association, which eventually merged with state guarantee stock association rather than liquidate).

[5]The respondent treated the merger as a reorganization within the meaning of section 368(a)(1)(A) of the Code and held that section 354 prevented recognition of gain or loss by the former shareholders of the mutual association on the disposition of their passbook and certificate accounts, *despite* the fact that nonproprietary deposits in the stock-type association were also received in the merger.

or "reject any application for savings accounts or membership" when it becomes in the best interests of the association and its members. Bylaws ¶ 7(e) & (f) (Jt. App. 50). This authority can be exercised, for instance, to protect against "insider trading" that might dilute the interests of the holders of accounts already issued and outstanding in the net worth of the association if a merger or liquidation is anticipated.[6]

Citizens Federal account holders likewise share ratably in any decrease in the value of the association's assets and, contrary to the respondent's assertion, which the Ninth Circuit found so persuasive, an account holder's investment in a federal mutual savings and loan association is not "risk-free." Obviously, the investment of any account holder in excess of the Federal Savings and Loan Insurance Corporation ("FSLIC") insurance coverage is totally at the risk of the business of the association. If the association fails, as did countless such institutions during the Depression and some modern day associations since then, none, or very little, of that investment may be recovered. *See, e.g.*,

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[6]In one much litigated case involving the merger of Long Beach Federal, a federal mutual savings and loan association, into a California guarantee stock-type association, the Board of Directors of Long Beach apparently did not act promptly enough to prevent such speculation, and the FHLBB took action on its own. In the merger, Long Beach account holders were to receive guarantee stock of the state association as payment for the value of Long Beach as a going concern. Prior to approval of the agreement by the FHLBB, there was an influx of large (over $100,000 each) investments in Long Beach accounts, which "had been opened . . . by 'celebrities of the financial and entertainment world widely known for their great wealth and business acumen.' " The FHLBB took the position that Long Beach management had breached its fiduciary duty to the existing shareholders by not rejecting these new applications for membership and required provisions in the merger agreement which in effect denied participation rights in the distributable guarantee stock to the extent that new accounts or additions to account balances after a fixed date exceeded $10,000. In addition, the provisions restricted "obvious 'insiders' " from participating in the distribution except to the extent of their accounts as of that date. *Federal Home Loan Bank Board v. Elliott*, 386 F.2d 42, 44-47 (9th Cir. 1967), *cert. denied*, 390 U.S. 1011 (1968).

Tcherepnin v. Knight, 389 U.S. 332 (1967) (account holders forced to bring a Rule 10b-5 suit under the Securities and Exchange Act to recover their investment).

Even the limited "insured" value of a share account holder's investment is at risk. That amount is not required to be paid in cash. The FSLIC has the option of meeting its matured obligations "by making available . . . a transferred account in a new insured institution in the same community or in another insured institution in an amount equal to the insured account. . . ." 12 U.S.C. § 1728(b) (1976). If the transferred account is a share account in a mutual association, it will be subject to the same withdrawal restrictions and risks of the business that were inherent in the original share account. Furthermore, the so-called insurance protection is only as sound as the corporation providing it. The FSLIC is the insurer of *all* federal savings and loan associations, and insures most state associations as well. In the event of an economic crisis threatening a significant number of insured associations, it would be impossible for it to cover all claims. Although the FSLIC's operations are supervised by the FHLBB, the FSLIC itself is not a governmental agency, and the United States is not liable for its obligations. The FSLIC has neither unlimited resources, nor is it guaranteed unlimited financial backing.

That Citizens Federal accounts represent a true equity interest in the association is further illustrated by an analysis of its obligation to make distributions on accounts. Although the respondent tries to portray these distributions as "interest," the facts do not support such a characterization. Unlike a depositor in a commercial bank, no Citizens Federal share account holder is legally entitled to a return from the association, either fixed or variable, on his investment. Rather, he receives dividends which are expressly dependent upon the financial success of the association. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). Distributions on accounts are made only out of profits of the enterprise, ratably according to the size of the investment, and, under federal regulations, cannot be made at all if the association's capital reserve account falls below a given level. 12 C.F.R. § 563.14 (1976) (Pet. Br. App. 4).

The amount of the distribution on accounts, if any, is determined and declared periodically by the Board of Directors. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). If the association is not profitable or its reserve and surplus are too low, no distribution will be made on any account, *and the association is liable for none*.[7] Charter K (Rev.) ¶ 10 (Jt. App. 43-44); *see also Federal Savings and Loan Insurance Corp. v. Huttner*, 401 F.2d 58, 61-62 (7th Cir. 1968) (holders of withdrawable shares in savings and loan association received dividends out of profits as declared by board of directors, not " 'interest' on money left on deposit"; consequently, FSLIC not liable for dividend expected by account holders but not credited before seizure of association due to impaired capital); *Lanigan v. Apollo Savings*, 353 N.E.2d 239, 242-43 (1976) (account holders in savings and loan association received dividends tied to profits and therefore have no right to post-default dividends despite availability of a liquidation surplus and belief that payments they had been receiving were "interest").

To our knowledge, no court has ever held that distributions made with respect to accounts in a savings and loan association are "interest." Instead, the courts have consistently held that such payments constitute dividends. *E.g., Federal Savings and Loan Insurance Corp. v. Huttner*, 401 F.2d at 61-62; *Fidelity Savings & Loan Association v. Burnet*, 65 F.2d 477, 479 (D.C. Cir.), *cert. denied*, 290 U.S. 652 (1933) (payments made to holders of passbook accounts are dividends paid on stock and do not constitute interest). The respondent himself took the same position for many years. Rev. Rul. 54-624, 1954-2 C.B. 16, 18. ("[D]istributions of earnings by Federal savings and loan associations constitute dividend income to the members of the as-

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[7]Although Citizens Federal is required by federal regulations to announce prior to issuance of certain types of "certificate" accounts the amount of dividends that it will distribute on those accounts *if net earnings are available to be paid out*, distributions on such accounts are also directly dependent upon the profitability of the association. Charter K (Rev.) ¶ 10 (Jt. App. 43). The association has no unconditional contractual obligation to make payments on any type of account. Similar terms are quite common for ordinary preferred stock.

sociations."); I.T. 4045, 1951-1 C.B. 34.[8]

In I.T. 4045, the Commissioner stated:

> The distinction between the term "dividend" and the term "interest" is that interest ordinarily means a payment arising out of a debtor-creditor relationship with respect to the use of money at a fixed, predetermined rate, *whereas a dividend is a distribution of profits to shareholders* which is conditioned upon the existence of profits and a dividend declaration by a board of directors or similar body.
>
> . . .
>
> . . . [D]istributions of earnings by Federal savings and loan associations constitute dividend income to the members of the associations. . . .

Id. at 35. This definition is in accordance with the respondent's current regulations. Treas. Regs. § 1.316-1.[9]

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[8]Rev. Rul. 54-624 and I.T. 4045 have been declared obsolete, but have not been revoked or superseded. They are simply "not considered determinative with respect to future transactions." Rev. Rul. 72-621, 1972-2 C.B. 651.

[9]The Ninth Circuit was "persuaded" that the payments of dividends by Citizens Federal did "not qualify the . . . accounts as equity" because of the deduction granted the association under section 591 of the Code. But as the Tax Court recently recognized in *Midwest Savings Association v. Commissioner*, 75 T.C. 262, 269 (1980), that section was enacted in 1951 specifically to grant a deduction to associations such as Citizens Federal *for dividends* paid to its shareholders which would *otherwise not have been deductible*, and was a clear recognition by Congress that the general Code provisions allowing a deduction for "interest" do not apply to such dividend distributions. *Id.* at 266. *See also Hudson City Savings Bank v. Commissioner*, 53 T.C. 70 (1969) (where respondent argued, and the Tax Court agreed, that section 591 of the Code is the exclusive statutory authority for the deductibility of distributions by corporations described therein). Certainly, neither this nor any other special tax benefit granted federal mutual savings and loan associations can alter the nature of the underlying relationship between the account holder and the association. Furthermore, the addition to the language of section 591 in 1962 of the words "or interest" was undoubtedly, as the court in *Midwest Savings* surmised, "intended . . . as a liberalization to make clear the deductibility of distributions of profits *whether denominated* dividends or interest." *Id.* at 270 (emphasis added).

In sum, the account interests issued to the petitioners in the merger carry all the rights and indicia of stock: the right to vote and control the association, the right to receive dividends in amounts periodically determined and declared by the Board of Directors out of net profits, and the right to share proportionately in the residual assets of the association upon its liquidation, or to realize on the appreciation of those assets through disposition of the business. These same attributes have caused every court that has directly addressed the issue, until the Ninth Circuit below, to conclude that savings accounts representing shares in a *mutual* savings and loan association are stock.

The contention that share accounts such as those issued by Citizens Federal evidence a debtor-creditor relationship has been repeatedly rejected in a variety of contexts and is contrary to this Court's own classification of an account holder's interest in a mutual savings and loan association. In *Tcherepnin v. Knight*, 389 U.S. 332, 345 (1967), *rev'ing* 371 F.2d 374, 377 (7th Cir. 1967), this Court concluded that the equity characteristics and investment risks present in mutual savings and loan share accounts were sufficient to characterize them as "stock" within the meaning of the Securities and Exchange Act. This Court held:

> *Petitioners are participants in a common enterprise — a money-lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans. Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits, the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends.* Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year. Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) and as it was defined in *Howey*. But we need not rest our decision on that conclusion alone. . . . *For example, the petitioners' shares can be viewed as "certificate[s] of interest or participation in any profit-sharing agreement." The shares*

must be evidenced by a certificate, and Illinois law makes the payment of dividends contingent upon an apportionment of profits. These same factors make the shares "stock" under § 3(a)(10).

389 U.S. at 338-39 (footnotes omitted and emphasis added).[10] *Accord, Fahey v. Mallonee*, 332 U.S. 245 (1947) (savings account holders of federal mutual association may bring stockholders' derivative suit).

The same characterization of the interest in issue was reached by the Court of Appeals for the District of Columbia Circuit in an opinion written by then Circuit Judge Burger. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714 (D.C. Cir. 1961), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962). The court there rejected a challenge that new regulations issued by the FHLBB unlawfully permitted federal savings and loan associations to accept deposits, and thus act as banks. In his concurring opinion upholding the new regulations, Judge Burger, while noting that there are many "superficial similarities" between mutual savings and loan associations and banks, stressed certain material differences between accounts in a federal savings and loan association and deposits in a bank:

> [W]e are *concerned not with appearances but with legal realities*; it is here that the differences are marked as Judge Miller has pointed out. *The capital of a federal savings association is raised by payments on share interests. Calling them "payments" on "savings accounts" does not alter their legal status. That the payment may be regarded by the customer as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor* as is the depositor in a bank. . . . *He is an investor, as the very language of Section 5(b) of the Home Owners Loan Act describes the relationship*. The owner of a "savings account" in the association is entitled to vote, in much the same way as a stockholder in a corporation, to elect the management. *The Act under which they exist recites the congressional purpose which emphasizes the "investment" character of these shares and distinguishes them from the creditor/debtor relationship between a bank account depositor and a bank.*

294 F.2d at 717-18 (citations omitted and emphasis added).

[10]The respondent has publicly ruled that section 354 is applicable when a stock corporation is merged into a farmers' cooperative and that certificates of interest received by the former stockholders of the acquired corporation constituted "stock." Rev. Rul. 68-22, 1968-1 C.B. 142; *see also* G.C.M. No. 33673, at 2.

2. The Code Definitions of "Corporation," "Stock" and "Shareholder" and the Legislative History of Sections 368 and 354 Demonstrate a Congressional Intent That Associations Such as Citizens Federal Be Covered by the Reorganization Provisions of the Code.

The Ninth Circuit's decision in this case would hinder desirable reorganizations of savings and loan associations, a result that is contrary to Congressional intent. Congress expressed concern that different types of corporations should not be singled out for more restrictive application of the reorganization provisions of the 1954 Code when it (1) rejected portions of a House bill imposing more limiting rules for nontaxable reorganizations of "closely held" corporations, and (2) decided against the inclusion within those provisions of any precise definition of the term "stock." On the latter point, Senator Milliken of the Senate Committee on Finance stated in the Committee's Report:

> The House bill departs from existing law by introducing the new terms, "participating stock" (corresponding in general to common stock) and "nonparticipating stock" (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term "security." Important tax consequences can flow from these definitions under the House bill. . . . *Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks* and securities *will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments*. Accordingly, your committee has returned to the use of the terms "stock," "common stock," "securities," etc., and, as is the case under existing law, *has not attempted to define them in the statute*.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 42 (1954) (emphasis added).

This language evidences a clear intent that the term "stock" for purposes of the reorganization provisions of the 1954 Code not be limited to instruments which are traditionally so denominated in common parlance. Moreover, by its refusal to define what would constitute "stock," Congress left for application to reorganizations the general statutory definitions contained in Section 7701 of the Code, which itself broadens, rather than limits, the term. Section 7701 includes within its express language the type of interests received by the petitioners. It states:

. . . .

> (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —
>
> . . . .
>
> (3) CORPORATION — The term "corporation" includes associations. . . .
>
> . . . .
>
> (7) STOCK — The term "stock" includes shares in an association. . . . [and]
>
> (8) SHAREHOLDER — The term "shareholder" includes a member in an association. . . .

I.R.C. § 7701(a). When these definitions are read together with sections 368 and 354 of the Code, which do "not otherwise distinctly express" what is meant when they use the above terms, the merger of Commerce and Citizens Federal comes precisely within the literal language of the Code.

Although, the reorganization provisions have been changed in some fashion or another in virtually every revenue act, Congress has never chosen to include in them a limiting definition of the key terms "stock," "shareholder" and "corporation." To the contrary, it repeatedly reenacted the above definitions, which clearly *expand* the meaning of the terms. Nor could this have gone unnoticed. In the Revenue Act of 1924, substantially the same guidance to the meaning of the word "stock" was contained in section 200(e), which provided that, "[w]hen used in this title . . . [t]he term 'stock' includes the share in an association. . . ."

Section 200(e) of the 1924 Act immediately preceded the sections dealing with corporate distributions and reorganization exchanges. Section 203(b) and (c) provided non-recognition of gain or loss upon the exchange of "stock or securities" in a corporate party to a reorganization.

Where Congress wished to qualify the breadth of the definitions of "stock" and "shareholder" contained in section 7701 (or its predecessors), or the application of the reorganization provisions to entities otherwise taxed as corporations, it did so in no uncertain terms. *See, e.g.*, § 247(b)(2) (defining "preferred stock" for purposes of the deduction for dividends paid on certain preferred stock) and former § 1361(m) (which expressly excluded certain partnerships and sole proprietorships electing to be taxed as corporations from the benefits of subchapter C of the Code, relating to corporate reorganizations); *see also* § 1083(f) (defining "stock or securities" for purposes of exchanges made in obedience to S.E.C. orders). The express qualifications of the term "stock," and of application of the reorganization provisions in other contexts, are yet further proof that Congress intended the term to be given its full meaning when used in sections 368 and 354 of the Code.

3. Without a Change in the Law, the Commissioner Abruptly Reversed His Position in the Mid-1960's on the Issue Presented, Even Though Prior to That Time He Had Consistently Treated Accounts in Mutual Savings and Loan Associations as Stock.

The respondent took the same position as the petitioners with respect to the nature of a mutual savings and loan association share account for many years. In Revenue Ruling 54-624, 1954-2 C.B. 16, 17-18, the respondent stated:

> A depositor in a bank has no voice in the management of the bank and he does not share in the distribution of the assets in the event of liquidation, dissolution or winding up of the business. However, each member of a Federal savings and loan association has, through participation in the election of a board of directors, a voice in the management of the association. In addition to the right to share in the profits, all holders of savings accounts are entitled to equal distribution of assets, pro rata to the value of their savings ac-

counts, in the event of voluntary or involuntary dissolution or winding up of the association. *The rights possessed by the shareholders of [a federal mutual savings and loan] association are in the nature of proprietary interests which are not at all similar to the rights of a general or special depositor in a bank.*

(Emphasis added); *accord*, Rev. Rul. 58-34, 1958-1 C.B. 333, 334 (no debtor-creditor relationship exists between a federal savings and loan association and holders of savings accounts in such association); I.T. 4045, 1951-1 C.B. 34 (account holders are proprietors rather than creditors of the association).

Not surprisingly, the respondent also agreed with the petitioners that transactions such as the one at issue here constitute nontaxable reorganizations. *See* G.C.M. No. 33551 (May 31, 1967); *see also Estate of W. T. Hales v. Commissioner*, 40 B.T.A. 1245 (1939) (wherein respondent conceded that the acquisition of all the assets and liabilities of a state-chartered savings and loan association by a federal mutual savings and loan association in exchange for the latter's stock (share accounts) plus cash was a reorganization under section 112(g) of the Revenue Act of 1934).[11]

In 1969, the respondent officially reversed his position with respect to transactions such as the one in issue. In Revenue Ruling 69-6, 1969-1 C.B. 104, the respondent announced for the first time his view that a statutory merger of a stock-type savings and loan association into a mutual savings and loan association did not qualify as a reorganization. G.C.M. No. 33551 (May 31, 1967), prepared in connection with Revenue Ruling 69-6, states:

> Our view [in Revenue Ruling 69-6] of the nature of a membership interest in a mutual savings and loan association represents a modification of the position previously taken by this office. In G.C.M. 30596 (April 2, 1958) . . . we

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[11]Section 112(g) defined a reorganization to include "the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation. . . ."

> expressed the opinion that such a membership interest consists entirely of stock. We therefore concluded that the acquisitions involved constituted nontaxable reorganizations within the meaning of section 368(a)(1)(C). . . .

It is true that the Commissioner may change his interpretation of the law. *Dixon v. United States*, 381 U.S. 68 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, *reh'g denied*, 353 U.S. 989 (1957). His interpretation, however, must have some basis in the law. There was no change in the statutes or the case law to warrant the respondent's "modification" of his position on the issue presented by this case, and there continues to be no support for the respondent's new position either in the Code or elsewhere. As a result, every court until the Ninth Circuit has justifiably spurned it.

4. All the Courts That Have Addressed the Issue, Except the Ninth Circuit in This Case, Have Concluded That Accounts in Mutual Savings and Loan Associations Are Stock Which Satisfies the Continuity of Proprietary Interest Test.

Over the past 15 years, the Court of Appeals for the Tenth Circuit, the Court of Appeals for the Sixth Circuit, the Court of Claims, the United States Tax Court and two district courts have all uniformly rejected the respondent's novel contention that share accounts in mutual savings and loan associations are equity interests for purposes of some reorganizations, but not for others. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Owens v. Commissioner*, T.C. Memo. 1983-302 (May 26, 1983); *Paulsen v. Commissioner*, 78 T.C. 291 (1982); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Only the court of appeals below strayed from this solid line of precedent and succumbed to the respon-

dent's urging that it rewrite the law.[12]

In 1979, the Court of Claims in *Capital Savings & Loan Association* was presented with the question whether the statutory merger of Franklin, a state guaranty stock-type association into Capital, a mutual association whose capital consisted solely of voting share accounts, qualified as a reorganization under section 368(a)(1)(A) of the Code. *Id.* at 971-72. The Government in *Capital* contended that the receipt of Capital's share accounts pursuant to the merger violated the continuity of proprietary interest test, asserting that the accounts were a debt interest, which it characterized as the "equivalent of cash." 607 F.2d at 974. Consequently, it argued, the merger did not qualify as a reorganization. Under the Government's theory, the transaction constituted a sale because the Franklin shareholders had "in fact, 'cashed in' or sold their equity interest . . . when they accepted [the Capital share accounts] for [their guaranty] stock." *Id.*

Relying upon the same attributes present in the petitioners' Citizens Federal accounts and applying to the transaction the continuity of proprietary interest test as enunciated by this Court, the *Capital* court rejected the Government's theory and held that the merger was a reorganization. The Court of Claims reasoned:

> Though savings accounts are easily converted into cash, *as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts*. Moreover, it must be observed that *the Government has admitted that Capital, a mutual association, is owned by its account holders, and this fact is inconsistent with its argument that these same accounts are debts if held by former holders of Franklin stock*. The nature of the Capital accounts, *i.e.*, the property interests in question, whether debt or equity, does not depend upon whether their holders were, prior to the acquisition by Capital of Franklin's assets, either holders of Franklin guaranty stock or holders of Capital savings accounts. Further, the debt or equity nature of savings accounts does not turn upon whether the accounts are exchanged in the merger of a mutual association into a mutual association or in the merger of a stock association into a mutual association. *Our inquiry must be into the nature of the proprietary interest in the affairs of Capital, if any, which rests in the holders of its accounts*.

Id. at 976 (emphasis added).

The *Capital* court likewise rejected the Government's argument "that there occurred an impermissible substantial change in the relationship of the Franklin shareholders because the value of the equity received [was] insignificant when compared to the value of the equity surrendered. . . ." *Id.* at 977. To this it responded, citing this Court's opinion in *Minnesota Tea Company*, 296 U.S. 378:

> Changes in the relationship of the former Franklin shareholder to the assets conveyed to Capital during the merger are permissible so long as the Franklin shareholder substantially continued his ownership interest in Capital. . . . This is *not* a case where an impermissible amount of *boot* and other securities was given *in addition to stock* as consideration for the exchange. In the transaction before the court, the *only consideration* which Capital could give or which the Franklin shareholders could receive, *Capital savings accounts, are proprietary interests* and in fact are the only proprietary interests in Capital.

Id. at 977 (citations omitted and emphasis added).

Finally, the *Capital* court expressly held that the redemption provision in the mutual association's charter (commonly denominated a "withdrawal" right) did not change its analysis and acknowledged, as the Government had warned in its brief, that its holding meant the former Franklin shareholders would not recognize any gain or loss on the transaction until they, partially or fully, disposed of their accounts:

> The focus must be on the nature of the interest itself; the duration of the interest does not control the determination

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[12] *Home Savings and Loan Association v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975), which was relied upon by the court of appeals in this case, did not involve a mutual savings and loan association. The transaction at issue there was an acquisition by a guarantee stock-type association of two other guarantee stock associations. Prior to the mergers, all the stockholders of the acquired associations had sold out for cash.

> of whether an interest is debt or equity. . . . As long as the Capital account holders do not withdraw, they continue to hold their proprietary interests in the corporation. [T]hen and then only will their proprietary interest, to the extent of their withdrawal, be eliminated, or, as characterized by defendant, be "cashed in."

Id. at 977; *accord, Ward v. Commissioner*, 29 B.T.A. 1251 (1934), *petition on appeal dismissed*, 79 F.2d 381 (8th Cir. 1935) (right to require repurchase of stock received in a reorganization does not invalidate the reorganization); *see also International Telephone and Telegraph Corp. and Affiliated Cos. v. Commissioner*, 77 T.C. 60, 76-77, *supp. op.*, 77 T.C. 1367 (1981), *aff'd on another issue*, 704 F.2d 252 (2d Cir. 1983).

Thus, as the Court of Claims correctly recognized, the withdrawal provisions in mutual savings and loan association charters are merely a means by which the account holder may, if he wishes to do so at some time in the future, dispose of his share interest in the association; they do not alter the underlying equity nature of that interest. As this Court has itself pointed out, "[t]he critical time [at which continuity of proprietary interest must be determined] is the date of the exchange." It "makes no difference that, in the long run," the instrument may be sold or converted into some other form of consideration. *Helvering v. Southwest Consolidated Corporation*, 315 U.S. 194, 201 (1942), *reh'g denied*, 315 U.S. 829, *second pet. for reh'g denied*, 316 U.S. 710 (1942).

Both the *Capital* decision and the Tax Court's decision herein were solidly grounded in precedent. Eight years before *Capital*, the Court of Appeals for the Tenth Circuit held that such accounts constituted "voting stock" of an acquiring federal mutual savings and loan association within the meaning of section 368(a)(1)(C) and (2)(B) of the Code. *Everett v. United States*, 448 F.2d 357, 359-60 (10th Cir. 1971). In *Everett*, the respondent argued that a mutual savings and loan association's share account "interest more nearly represents that of a creditor than a true proprietary interest and hence cannot be said to constitute 'solely voting stock'." *Id.* at 359.

The *Everett* court flatly rejected that argument. It pointed out to the respondent that the statutory continuity of proprietary interest test applicable to asset acquisitions under section 368(a)(1)(C) (which is stricter than the judicially created test) requires only that "at least 80 percent of the fair market value of [the transferor's] assets be acquired *solely for* voting stock of [the transferee]." The adverb "solely," the court correctly noted, "*does not impose a qualitative restriction on the nature of the stock thus given by the acquiring corporation*. So, the question as to whether the [share accounts] constitute 'voting stock' . . . is not answered by the argument that such is not 'solely' voting stock." *Id.* at 359 (emphasis added).

Two years later, the Court of Appeals for the Sixth Circuit, applying the continuity of proprietary interest test to a transaction virtually identical to the one in issue here, agreed with the *Everett* court. It held that the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, pursuant to which stock in the state association was converted into share accounts of the mutual association, satisfied the continuity of proprietary interest test and therefore qualified as a reorganization. *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974).

In *West Side Federal*, the respondent recognized that West Side's share accounts represented the entire equity interest in the association and conceded that section 7701 brought the merger within the literal terms of the reorganization provisions of the Code. *Id.* at 409. There again, however, he asserted his "dual interest" theory, arguing that the equity interest of an account holder in a federal mutual savings and loan association "was minimal compared to his rights as a creditor" and that the conversion of the state association's stock into voting membership accounts in the federal mutual association pursuant to the merger was in essence an exchange of stock for "cash or its equivalent." *Id.* at 406, 409, 411. Once again, the respondent's contention was rejected. *Id.* at 411.

The Sixth Circuit began its analysis by carefully reviewing the continuity of proprietary interest requirement as first adopted by

this Court in *Pinellas Ice & Cold Storage Company*, and as later defined by the Court when confronted with various factual situations. It stated:

> These cases teach us [that] . . . [t]he sellers must acquire "a definite and substantial interest in the affairs of the purchasing corporation" and the interest which they acquire must represent a substantial part of the value of the thing transferred. Nevertheless, there is no requirement that the relationship of the transferor or its shareholders to the assets transferred remain substantially unchanged. The interest which the transferor or its shareholders acquire must be at least in substantial part a proprietary or equity interest and where only cash or debt obligations of the transferee are received there is no qualifying reorganization.

494 F.2d at 409.

With these principles as its guide, the Sixth Circuit examined the respondent's position with respect to mergers and consolidations and found it fraught with inconsistencies. *Id.* at 409-10. It appears that whether the respondent treats mutual savings and loan association share accounts as an equity interest or not depends upon the result he wants to reach.

Finally, the Sixth Circuit noted that Charter K (Revised) contradicts the respondent's assertion that holders of share accounts in an association governed by it are creditors and found it "improper" for the respondent to ignore the proprietary rights represented by such accounts. The court concluded:

> In each of the cases dealing with continuity of interest the focus has been on the *nature of the interest* in the acquiring corporation which is received in the exchange. *The courts do not conduct an examination to determine whether the shareholder of the merged corporation receives more or less of a proprietary interest than he surrendered. Instead, it is an analysis to determine if a proprietary interest is received. . . .*

Id. at 411 (emphasis added).

Two district court cases followed the Sixth Circuit's decision in *West Side Federal Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979);

First Federal Savings and Loan Association v. United States, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Both found that accounts in a federal mutual savings and loan association constituted "voting stock" for purposes of the reorganization provisions of the Code and upheld as nontaxable reorganizations acquisitions of state guaranty stock associations by federal mutual associations.

Each of the foregoing courts and the Tax Court recognized that whether "the relationship of the taxpayer to the assets conveyed was substantially changed" was not determinative of the issue at hand. *Minnesota Tea Co.*, 296 U.S. at 386. Instead, expressly following the principles enunciated by this Court, they focused on whether the transaction "partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser." *Id.* That is, they asked what interest in the acquiring corporation the share accounts represented. Finding it to be an *ownership interest*, and therefore necessarily a continuing and "material stake in the affairs" of the modified corporate enterprise, those courts turned to the second part of the test: whether the instruments, the share accounts, representing that interest were received in exchange for "a substantial part of the value of the [stock or asset] transferred." 296 U.S. 385. In each case, as here, no other consideration was received and thus the transaction, otherwise within the plain language of the statutes, qualified for reorganization treatment under the Code.

The analysis of the Ninth Circuit in this case contrasts sharply with that of all the other courts. Although in its opinion the Ninth Circuit recites that the "interest received [by the shareholders of the acquired corporation in a reorganization] need not be the same form of equity interest given up," citing *Minnesota Tea Company*, it proceeds to ignore this Court's admonition and to construct a test of its own choosing.

As pointed out above, that new test, which the Ninth Circuit described as the "critical question" in determining whether a transaction qualifies as a reorganization, requires an inquiry into "whether the position of the shareholder in the reorganized entity has really changed: *has his risk increased or decreased? is his*

investment more or less liquid?" 716 F.2d at 569 (Pet. App. 30) (emphasis added). Thus, if the interest received is readily saleable, that interest cannot qualify as "stock" for purposes of the reorganization provisions of the Code under the test applied by the Ninth Circuit, because the shareholder would have "ready access" to his money. *Id.* The Ninth Circuit accordingly concluded that since the risk and liquidity of the petitioners' position changed, no reorganization exchange occurred. Yet this Court has stated that such change is not "inhibited by the statute."

II.

THE POSITION TAKEN BY THE NINTH CIRCUIT INHIBITS BONA FIDE BUSINESS READJUSTMENTS IN AN INDUSTRY CONGRESS HAS ENCOURAGED, ARBITRARILY DISCRIMINATES AGAINST MUTUAL SAVINGS AND LOAN ASSOCIATIONS (MOST OF WHICH ARE FEDERAL) IN FAVOR OF STOCK-TYPE SAVINGS AND LOAN ASSOCIATIONS, AND CREATES UNCERTAINTY IN THE TAXATION OF REORGANIZATIONS INVOLVING OTHER TYPES OF CORPORATIONS.

In its opinion in *Capital Savings & Loan Association*, 607 F.2d at 976, the Court of Claims stated:

> [W]e join the courts in *West Side* . . . and *Everett* . . . in refusing to reach a decision which illogically implies that Capital is an association without owners *and which may unduly hinder otherwise desirable reorganizations.*

(Emphasis added).

There is no doubt that the *Capital* court's concern was well-founded. The ability to reorganize two businesses without incurring a tax is of vital importance in any industry, and is crucial to the savings and loan industry because of its unusual sensitivity to the vagaries of the economy. The FSLIC itself often uses forced mergers as a means of bolstering an association which is in an unsound financial condition.

Since at least as early as 1921, both Congress and the Treasury have recognized the utility of allowing all corporations to respond to the exigencies of the economy and to business conditions through readjustments and combinations of their operations and

ownership structures without the imposition of immediate taxation. Section 202(c) of the Revenue Act of 1921 specified certain property exchanges on which no gain or loss would be recognized unless the property received in the exchange had a "readily realizable market value," but "*in addition* [specified] certain classes of exchanges on which no gain or loss [would be] recognized *even if the property received in [the] exchange has a readily realizable market value*. . . ." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921) (emphasis added). The exchanges in the latter category specifically included "cases . . . where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such a reorganization." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

Essentially the same provision dealing with deferral of taxation on reorganization exchanges has been reenacted in every subsequent Revenue Act, and, until about 20 years ago, mutual savings and loan associations were routinely engaging in nontaxable reorganizations such as the one in issue here with the Treasury's blessing. *See* G.C.M. No. 33551 (May 31, 1967), prepared in connection with Revenue Ruling 69-6, 1969-1 C.B. 104; *Estate of W. T. Hales*, 40 B.T.A. 1245 (1939) (discussed *supra* at page 30). Congress was obviously aware of those transactions, yet has never excluded mutual savings and loan associations from the benefits of the reorganization provisions.

To the contrary, the protection and encouragement of mutual savings and loan associations, in particular, have been a longstanding concern of Congress. Section 5 of the Home Owners' Loan Act of 1933, 12 U.S.C. § 1464(a) (1976), stated:

> In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the [Federal Home Loan Bank] Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations," and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home fi-

nancing institutions in the United States.

Until 1980, *all* federally chartered savings and loan associations were required to be organized in mutual form.

Congress has also conferred special tax advantages on mutual savings and loan associations. For years, it exempted them from taxation on their profits, which provided a competitive advantage over commercial banks. *See Midwest Savings Association v. Commissioner*, 75 T.C. 262, 266 (1980), and authorities cited therein. The Revenue Act of 1951 removed that exemption because the associations were accumulating profits instead of distributing them to shareholders, thus avoiding taxation altogether. In operation, however, Congress continued to favor mutual savings and loan associations over other corporations by allowing them a deduction for the profits they distribute to their shareholders and by providing them with more generous limits on bad debt reserves. *Id*; I.R.C. §§ 591, 593. Given its historical treatment of these associations, it is illogical to assume that Congress ever intended that they be singled out for adverse discriminatory tax treatment in the manner urged by the respondent and now condoned by the Ninth Circuit.

The position taken by the respondent places an unwarranted burden on savings and loan associations organized in mutual form by putting them at a distinct competitive disadvantage compared with stock-type savings and loan associations. Under the respondent's unique position, a mutual association can acquire another mutual association in a reorganization, but cannot acquire a stock-type association in the same manner. On the other hand, a stock-type association can acquire another stock-type association or a mutual association in a reorganization. Because a mutual association could not trade equity for equity to acquire a stock-type savings and loan association without triggering adverse tax consequences to the stock-type association and its shareholders, the mutual association would have to pay a substantially higher price to achieve the same type of bona fide business combination available to other corporations on a tax-deferred basis.

More than half of the savings and loan associations in this country (and nearly all federal associations) are organized in

mutual form. U.S. League of Savings Institutions, *Source Book* 36-38 (1983). Because the respondent's position would discriminate against the acquisition of stock-type associations by mutual associations, many potential beneficial business combinations would be inhibited for no logical reason if the decision below is allowed to stand. That such combinations are a vital means of growth in the savings and loan industry is evidenced by their frequency in recent years. Officials of the FSLIC have advised counsel for the petitioners that some 425 mergers of savings and loan associations took place last year alone.

The respondent claims that "serious practical and administrative problems" would result if mergers such as the one at issue are accorded reorganization treatment because every account withdrawal would result in gain or loss (Resp. Br. on Pet. for Cert. at 7). Contrary to the respondent's contention, it is no more difficult to calculate gain on the disposition of part or all of a share account than it is to calculate gain on the sale of a share (or fractional share) of any stock. If failure to report exchange account withdrawals are the respondent's concern, it is a simple matter for the Internal Revenue Service to require that such accounts be segregated (as they already are in all the mergers of this type which counsel for the petitioners have seen), and that appropriate informational returns be filed by the associations each year to show withdrawals by the holders of those accounts.

Respondent's "parade of horribles" also raises the specter that account withdrawals might give rise to dividend income if accounts are equity, but that concern, as well, is more imagined than real. Section 301 of the Code, which governs corporate distributions in general, already applies to withdrawals of share interests from associations. *See Cornwall v. Commissioner*, 48 T.C. 736 (1967). Section 302(b)(1) of the Code excludes from dividend treatment redemptions that are not essentially equivalent to a dividend. Certainly non-pro rata, sporadic redemptions of shares at face value that occur in a savings and loan association which routinely pays out its earnings and profits to its shareholders would not be treated as dividends under that section.

Somehow the Internal Revenue Service dealt with these "serious practical and administrative problems" prior to 1963. In any event, the Court of Claims readily answered the respondent's administrative lament when it pointed out that

> ease of collection is not a criterion of taxability which courts should apply. Potential accounting and collecting difficulties do not warrant our disregarding the substance of a transaction, *an equity for equity exchange*, and denying reorganization treatment when appropriate.

607 F.2d at 977-78 (emphasis added).

Finally, because of the test applied to reach their result, the decision of the Ninth Circuit and the respondent's position affect *all* reorganizations, not simply those between savings and loan associations, and therefore seriously undermine the "need for certainty in the [reorganization] law. . . ." 78 T.C. at 303 (Pet. App. 16). As the Tax Court below fully recognized, that need is great because of the high stakes and advanced planning associated with reorganizations. "The practicality of many reorganizations is materially affected, if not determined, by the tax consequences, and the participants need to know the ground rules." 78 T.C. at 303 (Pet. App. 16).

If shareholders must be concerned whether they have, in exchanging equity for equity, received a "more or less liquid" security, or "increased or decreased" their investment risk, their ability to predict the consequences of reorganization exchanges will be significantly reduced. Will a merger of a financially troubled corporation whose shares are not traded in the open market into a nationally traded company whose stock can be sold in an instant by a mere telephone call qualify for reorganization treatment? Certainly the exchanging shareholder's risk and the liquidity of his investment will be radically altered in the transaction.

Such a far sweeping change resulting from the new "test" adopted by the Ninth Circuit should not be lightly undertaken. Judge Featherston, in his opinion for the Tax Court, brought this case into true focus when he concluded with the admonition of Justice Powell in *United States v. Byrum*, 408 U.S. 125, 135, *reh'g denied*, 409 U.S. 898 (1972):

> When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

III.
CONCLUSION.

For the above reasons, the judgment of the court of appeals should be reversed.

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Respectfully submitted,

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APPENDIX.

[12 C.F.R.] § 546.4 [1976] Voluntary dissolution.

The board of directors of any Federal association may propose a plan for the dissolution of such association. Such plan may provide for (a) the Federal Savings and Loan Insurance Corporation to be appointed, in accordance with the provisions of section 406 of the National Housing Act, as amended, and section 5, Home Owners' Loan Act of 1933, as amended, and pertinent regulations of such corporation, as receiver for the purpose of liquidation; (b) all assets of the association to be transferred to another thrift and home-financing institution under Federal or State charter for a sufficient amount of cash to pay all obligations of the association and to retire all outstanding share accounts up to the amount credited thereto; (c) the transfer of all assets to another thrift and home-financing institution under Federal or State charter in consideration of the payment of all outstanding obligations of the association and the issuance of share accounts or other evidence of interest to the members of the Federal association on a pro rata basis; or (d) dissolution in such other manner as may be proposed by the directors and which to them appears to be to the best interest of all concerned. Such plan shall thereupon be submitted to the Board for approval, together with a statement of the reasons for proposing dissolution and the reasons for the plan submitted. If it appears to the Board that dissolution is advisable and that the plan of dissolution submitted is in the interest of all concerned, the Board will approve the plan; if the plan submitted appears to be inadvisable, the Board will either make recommendations to the association concerning the plan or disapprove it. When a play [sic] of dissolution has been approved [sic] the board of directors of a Federal association and by the Board, such plan shall be submitted to the members of such association at a duly called meeting and, when approved by a majority of the votes cast at such meeting, shall become effective. When dissolution has been consummated in accordance with the plan approved by the Board, a certificate evidencing that fact, supported by such evidence as the Board may require, shall forthwith be filed with the Board. Upon receipt of evidence sat-

isfactory to the Board that such dissolution has been so consummated, the Board will terminate the corporate existence of the dissolved Federal association and its charter shall thereby be cancelled.

[23 F.R. 9905, Dec. 23, 1958]

[12 C.F.R.] § 546.5 [1976] Conversion from Federal mutual to State charter mutual under last paragraph of subsection (i) of Section 5 of the Home Owners' Loan Act of 1933.

The following requirements are hereby prescribed for approvals pursuant to the last paragraph of subsection (i) of section 5 of the Home Owners' Loan Act of 1933, as amended:

(a) The conversion of an association shall be effected in accordance with a written plan approved by the Board, and in passing upon any such plan the Board may give consideration to any element of good-will value.

(b) The plan shall be submitted to the Board by action of the board of directors of such association prior to the giving of notice as hereinafter provided.

(c) The Board may prescribe such other substantive or procedural requirements as it deems necessary or proper to insure that the plan is fair and equitable to the association and its members.

(d) The association shall give formal notice of a special meeting called to vote on the plan, which shall be mailed, postage prepaid, at least 15 and not more than 45 days prior to the date of such meeting, and shall set forth the terms of the plan, the rights of the members, and such other matters as the Board may require. The use of said notice and accompanying proxy soliciting material, including the form of proxy, shall be authorized by the Board's Office of General Counsel before distribution is made to members.

(e) The plan shall be approved by a vote of at least a majority of the total votes eligible to be cast by members at the said special meeting.

(f) All requirements of or under State law shall have been complied with.

[40 FR 36310, Aug. 20, 1975]

[12 C.F.R.] §563.14 [1976] Payment of dividends and interest where losses are chargeable to the FIR.

No insured institution which has recognized losses chargeable to its Federal insurance reserve account may declare any dividends or pay any interest on savings accounts unless the amount standing to the credit of such account, after deduction of all such losses, is equal to at least the amount required under § 563.13. However, for any period when recognized losses are chargeable to such reserve and the amount remaining to the credit of such account after deduction of all such losses is less than the amount required under § 563.13, the declaration of such dividends or the payment of such interest on savings may be made if prior written approval is obtained from the Corporation. The Corporation hereby approves, for any such insured institution which has been insured for a period of 20 years or more and whose Federal insurance reserve account, prior to the charging of such losses, equalled at least 5 percent of all savings accounts, the declaration of dividends or the payment of interest on savings accounts, if such insured institution provides for the transfer to its Federal insurance reserve account of not less than 25 percent of its net income (as defined in § 572.3 of this subchapter) for such distribution period.

[37 F.R. 26581, Dec. 14, 1972]